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"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

J.M. Keynes, The General Theory of Employment
p.159, 1936, Reprint 1967

HIGHLIGHTS

The great question that has always haunted financial markets is what impact would the bursting of Japan's absurd asset-inflation bubble have on international financial markets and the world economy. Now the question has become real-life.

The Japanese economy and its financial system are going through a painful crisis that was simply inevitable. Japan deserves the distinction of having created the most spectacular financial bubble. Yet, it's by no means the only offender. Similar debt bubbles have occurred all over the world.

Japanese banks and investors are suffering savage losses at home and are repatriating capital from abroad. Logically, such moves ought to drive up the yen. We show why that hasn't happened.

What are the lessons to be drawn from Japan's experience for the other countries that have witnessed similar bubbles and excesses — the United States, Britain, Canada, Australia et al? We look at the differences and similarities.

What we see in Japan and the U.S. is anaemic economic activity and even slower money growth. Critically, such slow money growth signals that worse is yet to come for the asset markets.

Monetarism went out of the window in the 1980s due to a far too myopic view of inflation. As such, the decade witnessed the very first prolonged, globally-connected, asset-price inflation.

Experts should have known that this was an exact replica of what happened during the 1920s. The ignorance and benign neglect of the serious after-effects of asset inflation was the greatest policy error since the 1920s.

How is it that the U.S. stock market soars while the Japanese stock market collapses though the U.S. economy is clearly the weaker of the two? Considering the ridiculously inflated stock valuations and the tight money supply, U.S. stock prices ought to be half of what they are today.

Unprecedented weakness in private credit and broad money growth in most major countries — above all in the United States and Japan — allows little room for sustained economic recoveries.

Soaring budget deficits and rapidly ebbing international capital flows will have the effect of permanently raising long-term interest rates in the deficit countries, thus crippling the potential for sustainable economic recovery.

BOOM, BUBBLE, BUST

What is the difference between the economic situation of the United States and that of Japan? How is it that the U.S. stock market soars while the Japanese stock market collapses though the U.S. economy is clearly the weaker of the two? What is the difference between Fed-Chairman Alan Greenspan and Bank of Japan Governor Yasushi Mieno? We think it's useful to review these questions and developments from a longer-term perspective. The answers lead to some fascinating insights.

The whole saga really begins back in the second half of 1984 when the U.S. economy, following its jump start in early 1983, suddenly slowed down. It came as a surprise to most observers. The Fed was the first to panic and promptly slashed interest rates and again turned on its money spigots. What resulted was a strange and unprecedented combination of economic conditions: a faltering U.S. economy, declining inflation rates, a record credit and money expansion, an exploding U.S. trade deficit and a collapsing dollar.

The swooning U.S. dollar caused problems for countries abroad as their currencies correspondingly soared. To counter the contractionary effects of the steeply rising currencies on their economies, both the German and the Japanese central banks eased and lowered their interest rates aggressively. But whereas the Bundesbank kept a lid on money and credit growth, the Bank of Japan virtually panicked. In the course of events, Japan allowed a big credit and liquidity explosion. And as history amply bears evidence, a large part of this liquidity boom flowed into domestic and international asset markets, thus boosting prices and fuelling Japan's legendary asset-price inflation.

BUBBLE ECONOMICS

Why did these developments eventually lead to such extremes? There was a general willingness to accommodate soaring money and credit growth everywhere for a number of reasons: persistent worldwide economic weakness, the collapsing dollar and the conspicuous absence of consumer price inflation. Helped by sharply falling oil prices, inflation rates in 1986 actually declined to lows not seen since the early 1960s.

Several central banks, more or less, explicitly dumped their money growth targets concluding that money was no longer a reliable guide to prospects for output and inflation. Monetarism went out of the window due to a far too myopic view of inflation. It was the greatest policy error of the 1980s.

The bottom line, as we have so often explained in this letter, was that inflation had not really disappeared at all. Like a chameleon, it had merely changed its colours to match its surrounding environment. Inflation shifted its impact from the prices of currently-produced goods and services (price inflation as popularly represented by the consumer price indices) to areas which weren't recognized as being associated with inflation. While real GNP growth languished, the plentiful supply of money created during 1985-87 resulted in rapidly rising stock and property prices, falling interest rates and exploding international imbalances. Asset-price inflation appeared on the national and international scene with a vengeance and became a colossal lightning rod for excess money.

Everybody hates inflation when it happens to the things that one consumes . . . automobiles and groceries for example. However, no one complains about inflation affecting assets which they own or

stockpile. Asset owners, markets and banks love it, and, for that matter, so do governments. Asset-price inflation seems to make a community effortlessly richer, making them feel more wealthy. Governments and central banks, which otherwise are gravely concerned about rising prices in goods and services were sublimely unconcerned about the unfolding inflation in asset markets. In fact, soaring stock and bond prices were even hailed as the hallmarks of economic and financial health and were seen as the emblems of successful policies.

LIVE BY INFLATION, DIE BY ASSET DEFLATION

Considering that this was the very first prolonged, all-round, asset-price inflation, the general complacency was understandable in a way. Yet, the experts should have known better. They should have recognized that this was a replica of what happened during the 1920s in the U.S. when stock and property prices soared against a backdrop of perfectly stable price indices for goods and services.

In the 1920s, though, in contrast to the 1980s, the inflating stock and property prices had greatly alarmed the Fed. Despite the general price stability, it had repeatedly warned against the raging speculative fever and the related credit excesses on Wall Street. After easing in 1927, Fed policy turned around at the start of 1928 with the explicit aim of combatting speculation in the stock market without depressing the economy. The overriding fear of the time was that soaring credit growth was being applied to speculative activities at the expense of productive investment.

There's no evidence that any central bankers may have had sleepless nights in 1985-86 over the speculative mania that they had unleashed with their joint aggressive monetary easing. On the contrary, the booming stock markets and rising house prices were widely seen as the rosy signs of abounding prosperity and as a confirmation of the success of their policies.

As the year 1987 rolled in, the U.S. economy suddenly saw trouble from a number of fronts. Consumer price inflation perked up from below 2% to over 4%, and cripplingly, long-term government bond yields rose from a low of 7.75% to 10.25%. At the same time, a growing U.S. trade deficit incited concerns over the dollar. While the Bank of Japan further lowered its call-money rates, the Fed "snugged up" its Federal funds rate. During the summer of that year, most European countries — led by Germany — increased their short-term interest rates though less than in the United States. Meanwhile, the stock market mania continued unabated. On August 25, 1987, the Dow Jones Industrial Average peaked at 2,722. On October 19 and shortly thereafter the stock market crash cascaded around the world.

As far as the world economy was concerned, the stock market crash proved to be a false alarm. After the crisis had been stabilized, most central banks returned to a cautious monetary tightening. Yet, spurred by the prior phase of aggressive monetary easing, the world economy had started to accelerate in earnest.

JAPAN'S EXTRAORDINARY STORY

The Japanese stock market's reaction to the October 1987 U.S. market crash was particularly mild. Though Japan's economy also began to boom soon after, the Bank of Japan refused to do any tightening. After having lowered its discount rate in February 1987 to a historic low of 2.5%, it held it there for over two years until May 1989.

The result? More credit excesses, further leaps in stock and real estate prices, and a vast overheating of the Japanese economy. Thus, the "bubble economy" already boiling due an excessive monetary easing since 1985, got another boost. Soon the Tokyo stock market resumed its rapid rise and continued to soar until late into 1989. Real estate prices surged in lock-step.

Policy tightening in Japan only began in earnest in late 1989 when Yasushi Mieno took over as head of the Bank of Japan in November. It became his publicly avowed aim to purge the excesses of the bubble years. Within nine months he elevated the discount rate from 2.5% to 6% with the aim of squeezing credit though inflation as measured by consumer prices was only around 3%. Two weeks after Mieno's arrival, the Tokyo stock market peaked at 38,915 on the Nikkei Dow.

At the time in Japan, there was concern that the bubble of fantastical land and stock prices had grown to dangerous proportions spurring a wide consensus that it should be deflated before it destroyed Japan's financial institutions and markets. To the surprise of many people, Mieno kept his promise and continued to raise interest rates even in the face of sliding stock and land prices.

Within a period of a little over two years, the Tokyo stock market has lost about 60% of its peak value of late 1989. Ten years ago the Nikkei-Dow had been at a level of no more than 3,000. Remarkably, trading volume has collapsed to less than one-tenth of its former peak volume. In other words, very little money has escaped the downward vortex of the Japanese bear market. Most investors remain locked into huge and rising losses. Are they all waiting for an upturn? Meanwhile, Japanese real estate prices have fallen by as much as 30-40%.

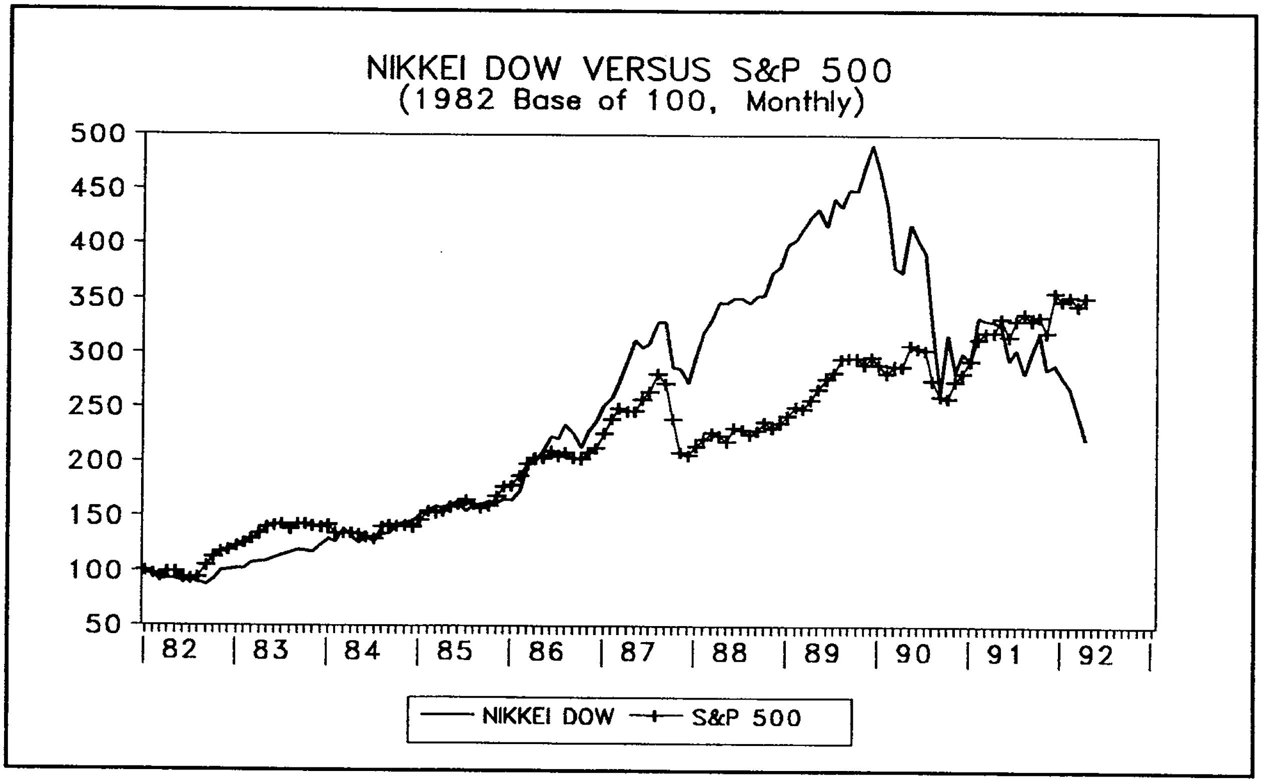
The great question has always been how the bursting of Japan's absurd asset-inflation bubble would impact its economy, the international financial markets and the world economy. Now the question has become real-life.

THE BILLS COME DUE IN JAPAN

In our view, the Japanese economy and its financial system are going through a painful adjustment crisis which had to happen sooner or later. The main victims of the current deflation are Japanese corporations, financial institutions and the banks — the very same that were the big speculators during the bubble years. These players have borrowed and lent in astronomic dimensions on absurdly inflated collateral values of stocks and real estate. Now that their values recede, the debts remain in full. And, on top of all the balance-sheet problems, now comes a widespread and savage profit squeeze. The pain is clearly spreading from the "bubble economy" to the real economy.

Essentially, corporations and banks have to retrench. Considering the size of the previous excesses, it will take years to clean up the financial mess and is bound to have some depressive influences on the real economy. Employment, though, remains buoyant. The main weakness centres on fixed investment, both residential and non-residential. Yet, the economy has slid very quickly recently, though from a very high level after years of rapid growth. It's worth remembering that since 1987, industrial production has risen a vigorous 21%. That compares with 19% growth in Germany and 7% in the United States.

Japan deserves the distinction of having fomented among the worst financial excesses but it's by no



means the only offender. Similar debt bubbles have occurred all over the world. In the case of Japan, though, there are some ameliorating factors. The government budget and the external current account are in surplus. Thus, there is no conflict between external and domestic policy requirements. If Japan fails to stabilize its economy, others which are weaker and more vulnerable are bound to fare worse.

More important from an international perspective, are two other questions: What are the lessons to be drawn for other countries that have experienced similar bubbles and excesses — the United States, Britain, Canada, Australia et al — and, how will Japan's financial crash and its economic problems reverberate and affect the rest of the world?

Recently, the U.S. Senate Committee on Banking, Housing and Urban Affairs was greatly comforted in this respect by the testimony of two important people. The one was Fed Chairman Greenspan. He said, "*these concerns, while understandable, seem to me exaggerated. As long as Japan continues to run current account surpluses, it must, by definition, be an overall capital exporter.*"

Even more sanguine sounding was the statement by Mr. Richard C. Breeden, Chairman of the U.S. Securities and Exchange Commission: "*A review of all the foregoing information makes it difficult to discern any significant direct correlation in price levels between the two stock markets (Tokyo and New York). Indeed, events in Japan seem to represent the removal of a 'bubble' caused by excess speculation, asset-inflation or other causes that were unique to Japan, and not replicated in the U.S., London, or other major world markets.*"

Such blindness is really hard to imagine. Japan's "bubble economy" was truly extraordinary . . . in fact,

extraordinary to the point of being unbelievable. Japan's financial excesses have no equal in magnitude. Yet, its bubble was not all that unique. Plainly enough, the busting of real estate and debt excesses is proceeding apace in America, Canada, Britain, Australia and some other countries. Asset-price inflation, both in real estate and paper values, was driven by rampant credit explosions in many countries. And as such, the inescapable consequence is a corresponding asset-price deflation. The only conundrum that still remains is why the grossly inflated stock markets — excepting Japan — have so far escaped the general asset crash. (See graph on the previous page).

The key difference between the Anglo-Saxon and Japanese "bubble economies" during the last two years is found in monetary policy — sharply easier in the former and sharply tighter in the latter. Remember what happened earlier in 1987, as we've already described. The situation then was reversed; Japan was loose while the U.S. and others were tightening. When the Fed began to tighten, both the U.S. bond and stock markets crashed while the easier money policy in Japan proved to be the saving grace of the Tokyo stock market.

There can be no question that the slashing of U.S. short-term interest rates to lows not seen in decades (causing an unprecedented gap between short and long-term interest rates) has literally chased people out of short-term assets and into mutual funds, bonds and shares. "*Cash is trash*" has become the new slogan. Plainly, the only visible effect of this forced flight from cash is rising stock prices. The low-low interest rates have miserably failed to lower long-term interest rates and to bail out the flagging real estate markets. Even worse, all the heavy pump-priming has failed to stimulate credit and broad money growth.

If both stock and real estate prices have been buoyed by the previous credit explosion, how can it be that they've gone off in opposite directions after the credit bubble has burst. Doesn't the real estate crisis imply a vast destruction of liquidity and capital? Of course, it does.

The enigma is explained by Joseph Schumpeter's comment in respect to the stock market mania of the 1920s, as we've quoted in previous letters: *"Comparatively small amounts go a long way on the stock exchange. Considerable booms can develop on a narrow basis of cash."* Barring great selling pressure or a large influx of new stock issues, a few billion dollars can easily move the stock market. By comparison, it would require hundreds of billions of dollars to lift bond and real estate prices. Just think of the $350 billion that alone is needed to finance the budget deficit.

THE REAL STATE OF THINGS

Again we quote Schumpeter: *"It remains true that irrational fancy and downright foolish hopes or fears count for much in the short run. But it is no less true that they never prevent the real state of things from asserting itself eventually."*

What, then, is the "real state of things"? The short answer: Continued unprecedented weakness in private credit and broad money growth in most major countries — above all in the United States and Japan — which allows no room for sustainable economic recovery. In particular, what's significant is that such anaemic money growth signals that worse is yet to come for the asset markets.

In Japan, the year-over-year growth rate of M2 has decelerated from 10% in 1989-90 to only 1.6%

recently. In the United States, unusually weak growth in broad money has become virtually habitual since 1989; M2 and M3 are up 2.8% and 0.7%, respectively, over a year ago. In both countries, money is expanding at rates less than nominal GNP growth.

What we see then in both countries is anaemic economic activity, yet even slower money growth. In Japan's case, the stock market's decline jibes perfectly with the collapse in money growth. That makes sense at least. In the U.S. case, on the other hand, nothing makes sense of the rising stock prices, neither stock valuations nor corporate earnings nor shrinking overall liquidity.

This prolonged stock market boom, to be sure, is not "earnings-driven." On the contrary, profit margins have steadily fallen to historical lows. Even if profits were to recover somewhat, they nevertheless remain near secular lows as a percent of GNP. Nor is the boom "liquidity-driven". By definition, to have the latter occur would require that the money supply grows faster than nominal GNP. The usual explanation is this: In the absence of strong money demand for economic activity, the "excess" money flows into financial assets by default thus boosting their prices. In reality, however, U. S. broad money growth has been falling short of nominal GNP for more than two years. The alleged "liquidity-driven" bull market is nothing more than a Wall Street fable. What has been propelling U.S. stock prices is a mix of fancy stories, fervent hopes and frantic desperation about low interest rates.

Considering the ridiculously inflated stock valuations and the tight money supply, U.S. stock prices ought to be around a half of what they are today. Yet, reputable Wall Street firms still counsel that stock prices are fairly valued or even slightly undervalued and that the "bull" market still has years to run.

THE MANY AFTER-EFFECTS OF INFLATION

Most people still seem incapable of grasping the great destructive forces that have been unleashed by the asset-inflation bubbles of the 1980s and their effect on the financial structure and the economic fundament of the countries concerned. Due to a widespread ignorance about the nature of asset inflation and a false comfort derived from relatively low product-price inflation, central banks were lulled into fostering and permitting unprecedented debt excesses.

This brings us to the most harmful effect of inflation — one that's generally disregarded. The orgies of borrowing, fuelled by the asset inflation bubbles, have also caused huge malinvestments and structural maladjustments in the real economies. These particular effects of credit excesses depend on the specific use to which the borrowed money was applied and the way it coursed through the economy and the financial system.

The most obvious maladjustment affecting all the countries that caught the asset-inflation virus is, of course, the reckless overbuilding in commercial real estate. In addition, however, the prolonged credit excesses also grossly imbalanced the consumption-investment proportions in the "bubble economies." In other words, big shifts within aggregate GNP took place between consumption and investment.

JAPAN AND THE U.S.: TWO OPPOSITE EXTREMES

Interestingly, credit excesses had exactly the opposite structural effects in Japan and the Anglo-Saxon

countries. In the latter, the inflationary wealth effects overstimulated private consumption, while in Japan, investment was overstimulated instead.

In the United States, the share of personal consumption in GNP rose from 63% in the 1970s to 68%, from 60% to 64% in Britain, and from 59% to 65% in Canada. Fixed capital formation declined over the same period as a share of GNP from 19% to 14.5% in the United States, from 19% to 15% in Britain and from 15% to 12% in Canada. In Japan, by contrast, fixed investment rose from 28% of GNP in the first half of the 1980s to as high as 34% recently.

In the Anglo-Saxon countries the asset bubble fuelled an unsustainable consumption boom while in Japan it fuelled an unsustainable investment boom. For good reason, therefore, economic weakness in the United States is centred in consumption and in Japan in investment. The last thing that America needs, given this exorbitant rise in consumption, is still more of it. Yet, that's exactly what everybody, including the government, is pushing for.

There is yet another important difference between the Japanese and Anglo-Saxon bubbles. Japan, being a country with a huge current-account surplus, flooded the asset markets worldwide with its excess liquidity. At the receiving end of all this liquidity were primarily the Anglo-Saxon countries, all of them being inflation-prone with a large current-account deficits and high interest rates. In the last analysis, the explosion of international capital flows enabled the deficit countries to inflate without the normal balance-of-payments constraint.

But in 1991, the pattern of international capital flows changed dramatically. Unification stopped the outflows from Germany and, for different reasons, Japanese outflows also fell sharply. Instead, foreign capital poured into the Japanese securities markets. Foreign net purchases of Japanese equities came to a total of $46 billion in 1991. Why? International investors thought that Japanese stocks looked cheap after their first price collapse. These investors have since, of course, borne heavy losses for their folly.

CAPITAL FLOWS AND THE YEN

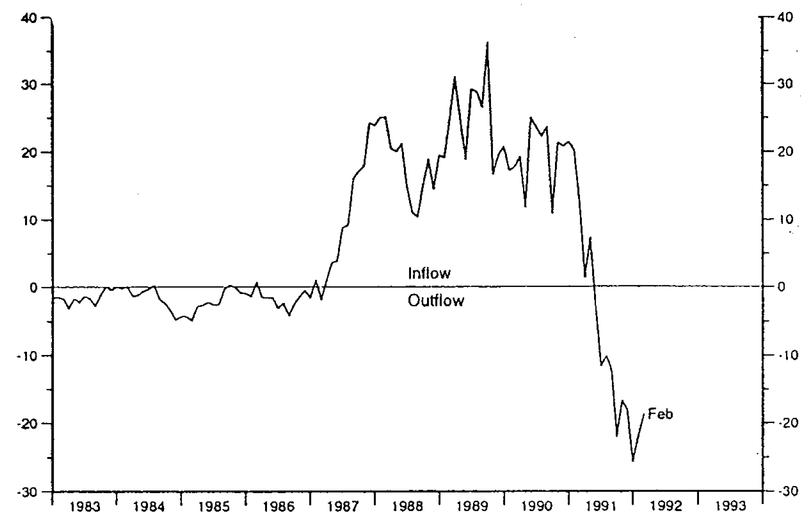
It has become the great worry that Japanese banks and investors, suffering savage losses at home, would massively repatriate capital from abroad thereby shaking foreign markets. Logically, such a move ought to drive up the yen.

Actually, in 1991, Japan had a current-account surplus of $73 billion plus net long-term capital inflows of $37 billion. Together, that really should have sent the yen skyrocketing. Yet, it didn't work out that way because of huge offsetting short-term capital outflows. Given record-low dollar interest rates, these flows seem puzzling. However, there is a different cause at work. Japanese banks, whose capital base is eroding with the stock market crash, are shrinking their balance sheets by reducing both foreign assets and liabilities. It's the liabilities, though, that are being reduced at a much faster pace. These liabilities are an inheritance of the crazy 1986-88 years, when Japanese institutions acquired foreign investments far in excess of the country's current surplus. To do so, they borrowed heavily in foreign currencies — mostly in the hard low-yielding currencies — which they are now repaying thus accounting for the surprising weakness of the yen against the dollar.

During the 1983-90 — the "bubble era" — Japan had gross capital outflows of more than $700 billion. Of this amount little more than $300 billion, or less than half, was covered by the current-account surplus. The greater part, — roughly $400 billion — was mostly financed by bank and corporate borrowing abroad in foreign currencies. Short-term bank borrowing accounted for about half of that. The other big item was corporate borrowing by way of bond-linked warrants.

JAPAN: SHORT-TERM CAPITAL FLOWS

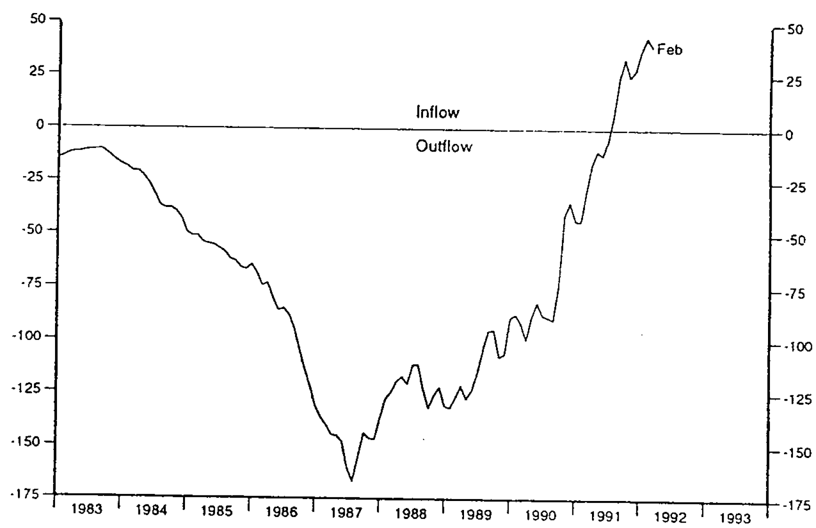
12-month sum, billion dollars



Source: C.J. Lawrence

JAPAN: LONG-TERM CAPITAL FLOWS

12-month sum, billion dollars



Source: C. J. Lawrence

U.S. INFLATION OR DEFLATION?

In the United States, one bubble has clearly and definitely burst: real estate. The most dangerous facet is represented by commercial mortgages which amount altogether to $750 billion. The commercial banks, thanks to aggressive lending in past years, hold about $340 billion of these.

For the reasons explained, the U.S. stock market bubble is still existing pretty well unhindered. Another bubble isn't doing so well — U.S. Treasury bonds. In any case, the Treasury bond bubble is nearly as confusing as the "made in Japan" excesses. Given the soaring U.S. budget deficit, the massive money creation that it involves, and the Fed's huge reserve injections into the banking system, why then, isn't inflation heating up?

Last year, the Federal budget deficit amounted to $269 billion, up from $220 billion in 1990 and $153

billion in 1989. Of the net new treasury bond issues in 1991, the Federal Reserve System bought $31 billion and commercial banks purchased $114 billion. Furthermore, foreign bond purchases amounted to $45 billion. None of the latter constituted "capital inflows," though. All that really happened was that foreigners borrowed in the Euro-market at cheap rates and paid it to the U.S. Treasury (by buying treasury bonds) which in turn spent the money into U.S. circulation. Adding it all up — the purchases of central and commercial banks and non-resident purchasers — means that roughly $190 billion of last year's U.S. budget deficit was financed by money creation.

Other buyers of Treasuries were life insurance companies ($56 billion), private and public pension funds ($52 billion), and money market funds (another $38 billion). The biggest sellers were S&L's. As a matter of fact, bond purchases rose steeply in the second half of last year. Expectations of further Fed interest rate cuts obviously unleashed a speculative stampede.

Surely, much of this buying was just yield-curve play. Curve players exploit the spread between low short-term rates and higher long-term rates by borrowing short-term and buying long-term. But the main attraction to these speculators are the potential capital gains on the purchased bonds in the hope that the Fed's progressive monetary easing and falling inflation rates will bring down U.S. bond yields to 7% and lower. Most unkindly, however, bond prices have marched in the opposite direction since the Fed's generous 1% cut in its discount rate last December. Lots of speculators must be stuck with severe losses.

THE WEAK LINK: LONG-TERM BOND YIELDS

It was, in our view, mainly three things that lowered U.S. bond yields last year even in face of a rising budget deficit: firstly, money creation; secondly, yield-curve play; and thirdly, shrinking domestic private credit demand.

This year, the budget deficit is anticipated to surge to about $350 billion. In trying to assess how this surge of new borrowing will impact long-term interest rates, we essentially have to do some guessing about the demand for these bonds. As a start, we need to consider the trend of the economy.

To prevent a rise in bond yields, and given that the supply of U.S. savings is not expected to improve, what's needed is a new wave of speculation and yield-curve play. But, in order for that to happen, there must be a deepening recession to allow more Fed easing and lower short-term interest rates.

Contrarily, if Wall Street is right about a genuine economic recovery, how would the bond market react? Economists would wave the banner of the "earnings-driven" stock market boom, of course. But the banks and all the other yield curve players would unload their bond portfolios in a panic. As a result, the bond bubble would be the first to burst in turn pricking the balloon of stock prices. Remember 1987?

In our view, any movement in the economy will not be strong enough to provoke serious Fed tightening. Even in this instance, we doubt that long-term interest rates have significant room to fall, given the much higher budget deficit and poor savings levels. Private credit is already so weak that to have even slower growth seems unimaginable.

That also hints at the reason why the rampant money creation fuelled by the combination of a mammoth budget deficit and a most aggressive monetary easing has no visible inflationary effects. The inflationary budget gap has a direct counterpart in a deflationary private credit collapse. The relationship between private and public credit has dramatically reversed as we've pointed out in recent letters. In 1985, private credit growth of $669 billion coincided with a budget deficit of $225 billion. Last year, it was $187 billion in private credit growth against a budget deficit of $265 billion. In 1985, total credit grew by 14.9%. Presently, it's only 3.1%.

IT'S CALLED A "CROWDING-OUT"

It's a mute question whether this credit deadlock in the U.S. private sector is caused by unwilling lenders or unwilling borrowers. The decisive point is that it restricts money creation and purchasing power. The ominous part is that the desired credit expansion fails to materialize though the banks are flush with reserves and liquidity.

Economic logic says that there are deeper causes lying in the adverse cost-price-profit conditions which act to choke off investment and production. One only has to look at the widespread, savage cost-cutting as confirmation. More precisely, it's the coincidence of record-low business profit margins and stubbornly high long-term interest rates. Why the latter?

What's really occurring is a textbook case of a long-term "crowding-out." While a rising budget deficit has expansionary effects over the short run, it weakens capital stock and productivity growth over the long haul as it keeps long-term interest rates structurally high. Hayek called it *"capital consumption."* Its effects start ever so slowly, but if continued over many years, starts to breed a lethal combination of sluggish income growth, chronically high inflation and ever-growing deficits. In America and some other countries, these nefarious, long-term structural effects are out in full force.

All the frantic inflationary actions, both through U.S. fiscal and monetary policy, have so far failed to rekindle price inflation. That's because the outlets of stimulation into the profitless economy are clogged. Instead, the new money, created so massively, flows unabated into financial speculation. The buoyant markets, in turn, encourage optimism, if not euphoria.

There won't be a sustained recovery unless private credit returns to a normal growth rate of a least 6 to 7%. It's expanding at only 2-3% presently. What we see is a clash between highly inflationary policies and deflationary market forces occasioned by the past excesses. Up until now, the Fed has failed. Yet, it cannot allow deflation to take over. We expect, therefore, more futile easing.

There is bound to come a point in the near future when the markets become more critical of the Fed's policies. It's low productivity growth that keeps the U.S. economy inflation-prone, but to get really alarming inflation would require a slumping dollar.

CONCLUSIONS

Despite sharp cuts in short-term interest rates in the major countries, world economic growth has remained weak. Generally, growth forecasts for 1992 have been slashed. With little thought or question, growth forecasts have merely been shifted forward to 19[illegible] The eternal optimists are focusing

only on the sharp declines in short-term interest rates and are studiously ignoring the stubbornly high long-term rates.

Soaring budget deficits and rapidly ebbing international capital flows will have the effect of permanently raising long-term interest rates in the deficit countries, thus crippling the potential for sustainable economic recovery. In the case of the U.S., the massive yield-curve speculation makes its bond market particularly vulnerable.

Mr. Greenspan's complacent view that the Japanese current-account surplus will guarantee an outflow of funds is grossly mistaken. If Japanese banks use the inflows from the country's current-account surplus to pay off their short-term liabilities abroad, international liquidity in the form of inter-bank liabilities will shrink. The amount involved is considerable; last year it was $93 billion.

The Bank of Japan's reluctance to ease more aggressively does not reflect concern about inflation — it's a low 2% — but a fear of re-kindling the former speculative bubble. The risk of a recession has to be taken.

The same applies to Germany. As Germany struggles to realize lower long-term inflation and to bring the financing of unification under control, the rest of Europe remains stuck with relatively high "made in Germany " interest rates because no EMS country wants to weaken its currency. The European bond market, although remaining attractive with high interest rates, will likely undergo more sideways action before resuming its uptrend. More about Germany and Europe in the next letter.

The only central bank in the world that is desperately trying to reflate is the U.S. Federal Reserve. That's what distinguishes Mr. Greenspan from Japan's Mr. Mieno and all of the other central bankers. For the time being it's fanning up Wall Street , fostering complacency and buying some time. The "*real state of things*," though, leaves no ground for long-term optimism.

Despite the grimmest confluence of economic and financial developments that the world has seen in many decades, there's remains a stubborn unwillingness to recognize anything that might end the financial gravy train a minute too soon. It's only that complacency that stands between the final reckoning.

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